No. 18,224

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAUDE C. WOOD COMPANY, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE PETITIONER

LOUIS F. OBERDORFER,
Assistant Attorney General.

LEE A. JACKSON,
MELVA M. GRANEY,
MICHAEL MULRONEY,
Attorneys,
Department of Justice,
Washington 25, D. C.

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 59-70)[1] are not officially reported.

JURISDICTION

This petition for review (R. 56-58) involves federal income tax for the taxable year 1958. On May 27, 1960, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in in-

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[1] Record references are to the printed Transcript of Record.

come tax in the total amount of $9,347.35. (R. 12-16.) Of this amount, $8,760 is in controversy. (R. 5, 59.) Within ninety days thereafter, on June 22, 1960, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code. (R. 3, 5-16.) The decision of the Tax Court was entered April 9, 1962. (R. 55.) This case was brought to this Court by a petition for review filed June 27, 1962. (R. 56-58.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in holding that the taxpayer is entitled to a percentage depletion allowance under Sections 611 and 613 of the Internal Revenue Code of 1954 on tailings of sand, gravel and cobbles remaining from gold dredge mining operations.

STATUTE INVOLVED

The applicable statute is set forth in Appendix A, *infra*.

STATEMENT

The facts of this case, drawn from the stipulation of facts. (R. 19-21), exhibits (R. 21-54),[2] testimony

[2] The parties stipulated, with the approval of the Court, to exclude several of the exhibits from the printed record. (R. 139-140.)

(R. 71-138), and findings of the Tax Court (R. 59-67) may be stated as follows:

The taxpayer, Claude C. Wood Company, a California corporation, operates a rock, sand and gravel business. (R. 59.) In 1958, the taxable year in question, it operated from the Featherston, Putnam Ranch and Wright properties in San Joaquin County, California. (R. 19-20.) Its operations on all three properties were carried out under agreements which gave it the exclusive right to remove the rock, sand and gravel which had been unearthed in prior gold dredging operations on the land. (R. 33-49.)

The agreement relating to the Featherston properties under which the taxpayer operated provided that the taxpayer would purchase all the sand and gravel removed from the owner of the property at a stated rate per ton, subject to an agreed minimum payment. (R. 34-35.) The agreement under which the taxpayer operated on the Putnam Ranch property was similar in this respect. (R. 39-42.) The agreement under which the taxpayer operated on the Wright property provided that the owners of the property sold to the taxpayer for $9,375 all rock, gravel and sand remaining on the property after previous dredging operations. (R. 43-48.) The taxpayer operated under these agreements during the taxable year in question. (R. 59-62.)

The gold dredging operation preceded the taxpayer's operations on the properties. Before the dredging operation commenced, the general geologic cross section of the properties was bedrock on top

of which was an alluvium deposit 30 to 40 feet thick. (R. 89, 94, 103.) The alluvium contained aggregates of sand, gravel and cobbles.[3] (R. 62-63.) When in place as an alluvial deposit, sand and fine gravel filled the voids between the cobbles. (R. 63, 90, 96.) Free gold was also intermingled with the sand, gravel and cobbles. (R. 90.) On top of the aggregates was a layer of topsoil and vegetation. (R. 62-63.)

In determining whether a property was suitable for dredge mining for gold, borings were taken to determine the gold content, the character of the subsurface, and the depth at which bedrock lay. (R. 63, 85, 94.) If the property was acceptable, the topsoil and vegetation were removed to expose the alluvium. (R. 65, 100.) A pit was then dug in which the dredge was constructed on a watertight platform. (R. 63, 85.) The pit was flooded to float the barge. (R. 63, 64.)

The dredge was a ponderous machine. (See Ex. 9-I.) The barge was 150 feet long. (R. 64.) Extending forward from it was a digging ladder 75 feet long bearing scoops on a conveyor belt which dug and carried the gold-bearing aggregates to the barge. (R. 64, 87-88.) Extending backward from the platform was a stocking ladder, an arm 125 to 150 feet long, which conveyed gravel and cobbles from the barge to deposit them behind the barge. (R. 64, 66.)

The dredge in operation scooped up all the material above bedrock with the scoops at the end of its digging

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[3] Cobbles are rounded stones from 4 to 12 inches in diameter. (R. 127-128.)

ladder and conveyed the material to the barge. (R. 65, 87-89.) There, the aggregates were tumbled in a trammel, a cylinderical rotating perforated screen, in which they were washed and screened to separate the small particles of gold and sand from the unwanted gravel and cobbles. (R. 65, 88-89.) The gravel and cobbles were then conveyed 150 feet backward to the end of the stacking arm and dumped. (R. 87, 88, 96-100.) Quicksilver separated the gold from the fine sand with which it had passed through the trammel screen and the sand was discharged into the pond immediately behind the barge. (R. 65, 88-89, 91, 96-100.) Thus, the gravel and cobbles were moved from their original position at any given point on the property some 300 to 350 feet while the sand from the same place was moved about 200 to 225 feet. (R. 64, 91, 92, 96-97, 98.) The dredge dug its way about the property by displacing the material in front of it and depositing it behind. (R. 66, 85, 86, 89-90.) The sand was discharged closest to the machine while the cobbles and gravel were later deposited on top as the dredger moved forward. (R. 66, 89-90, 118.) Since the voids in the gravel and cobbles deposited by the dredger were not filled with sand as in their natural state, the volume or "swell" of the discharged aggregate was 35 to 40 percent greater than it had been in the natural state. (R. 66, 96.)

The cross section of property which has been worked by a dredger of this sort is bed rock, covered by a layer of sand which in turn is covered by a layer of gravel and cobbles with no covering of topsoil.

The dredge's function was one of separation and displacement rather than crushing or grinding of the aggregates it dug. No chemicals were added to the aggregate. (R. 65, 91.)

The deposits remaining after the dredge had worked a property are customarily called a tailing pile. (R. 66, 114, 117.)

As noted above, the taxpayer purchased these dredger tailings. It dug them from the place in which the dredging operation deposited them with draglines and hauled them to its plant for processing. (R. 66, 125.) At the plant the sand, gravel and cobbles were processed into the kinds of rock and sand products which the taxpayer sells.[4] (R. 66-67, 125-127.)

The taxpayer's processing operations differ for dredged and natural aggregate materials. With natural materials sand and rock are mixed, but with dredged materials they have been separated. (R. 67, 130-131, 134.)

On its 1958 income tax return the taxpayer claimed a percentage depletion deduction of 5 percent on the material from the three properties. The Commissioner disallowed the deduction and the taxpayer petitioned the Tax Court. (R. 6, 14-15, 67.) The court decided the taxpayer was entitled to the deduction. (R. 55.) The Commissioner petitioned for this review of that decision. (R. 56-58.)

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[4] The taxpayer sells concrete sand, plaster sand of various sorts, pea gravel used for driveways, crushed rock for highway use, concrete aggregate, septic drain rock, crushed rock for making concrete blocks and turkey grits, sand for tomato seed beds, and rock for fill material. (R. 54, 67.)

SPECIFICATION OF ERRORS RELIED UPON

The Tax Court erred—

1. In finding that the aggregates taken by the taxpayer from three properties in 1958 were natural deposits. (R. 67.)

2. In concluding that the taxpayer is entitled to a percentage depletion deduction on rock, sand and gravel which it removed from property that had already been dredge-mined for gold. (R. 68-70.)

3. In failing to hold that the aggregates were taken from the waste or residue of prior mining (a matter which the court did not discuss).

4. In failing to hold that the taxpayer was the purchaser of waste or residue or of rights to extract mineral therefrom and therefore expressly prohibited from obtaining a percentage depletion allowance under Section 613 of the Internal Revenue Code 1954 (a matter which the court did not discuss).

5. In entering decision in favor of the taxpayer and failing to enter decision in favor of the Commissioner. (R. 55.)

SUMMARY OF ARGUMENT

1. The 1954 Code allows percentage depletion in the case of "mines and other natural deposits." The term "mines" (and by statutory inference, "other natural deposits") is specifically defined to include "waste or residue of prior mining" but with an important exception, i.e., that worked by a purchaser of such waste or residue or of the right to extract mineral therefrom. Without discussing this provision, the Tax Court found that the aggregates taken from three properties by the taxpayer were "natural de-

posits" and held that the taxpayer was entitled to percentage depletion on them.

2. The term "mines and other natural deposits" has been in the statute for many years, but prior to the 1954 Code the term "waste or residue of prior mining" did not appear. Nevertheless, questions arose as to whether waste and residue such as tailings piles and ore dumps from prior mining operations could be the subject of a depletion allowance by persons other than the original miners who later extracted minerals from the waste. Several courts, including this one, considered the problem. The issue in those cases was whether such waste or residue deposits were included in the statutory term "mines and other natural deposits." The appellate courts uniformly held they were not.

The decisions outline the tests for determining whether a mineral deposit comes within the term "mines and other natural deposits." In sum, they indicate that a natural deposit did not include a tailings dump deposited on the surface of the land resulting from residue of ore that had been severed and milled; that natural deposits cannot be artificially created or result from prior mining; and that to be a natural deposit, the material must be in its natural location, in its natural state and unrefined by the removal of any materials. The taxpayer's aggregates deposits do not fit these judicial tests, and do not come within the statutory term "other natural deposits."

3. The same decisions which deal with whether waste or residue are natural deposits also consider

what constitutes waste and residue. They show that tailings, ore which has previously been worked, are residue and waste material; and that waste is material thrown aside and discarded from prior mining operations. The aggregates which the taxpayer extracted were found by the Tax Court to be tailings from the dredging operations. Such aggregates were both waste and residue of the prior gold mining operations. They thus fall directly within the statutory term "waste or residue of prior mining operations."

4. The Code, by definition, excludes from the percentage depletion provisions a "purchaser of * * * waste or residue or of the rights to extract ores or minerals therefrom." The taxpayer was such a purchaser. Each of the agreements under which it operated during the taxable year in question provides that the owner of the aggregates sold them to the taxpayer, either for a lump sum or on the basis of amounts extracted. The taxpayer is therefore not entitled to a percentage depletion allowance.

5. The Tax Court's finding that the aggregates were "natural deposits" is not binding on this Court. In making that finding, the Tax Court failed to apply the proper test of "natural deposits" and compounded its error by failing to recognize and apply the legislative intent with respect to the waste or residue of prior mining. Moreover, even if the court had not erred as a matter of law, its finding that the aggregates were natural deposits, and thus subject to percentage depletion, would be clearly erroneous.

ARGUMENT

The Tax Court Erred In Holding That the Taxpayer Is Entitled To a Percentage Depletion Allowance Under Sections 611 and 613 of the Internal Revenue Code of 1954 On Tailings of Sand, Gravel and Cobbles Remaining from Gold Dredge Mining Operations

A. *Introduction*

Section 611(a) of the 1954 Code (Appendix A, *infra*), permits a deduction for depletion in the case of "mines, oil and gas wells, other natural deposits, and timber." Section 613(a) (Appendix A, *infra*) requires that in the case of "mines, wells, and other natural deposits" the depletion deduction is to be determined on the basis of a percentage of income from the property. The phrase "*other* natural deposits" (emphasis supplied) in both sections demonstrates statutory recognition of the obvious, i.e., that "mines" are a natural deposit, but that they are a specific kind of natural deposit. Stated another way, the Code says, in effect, that all mines are natural deposits, but that not all natural deposits are necessarily mines.

Section 611(a) goes on to provide a specific definition of "mines." It states that, for purposes of the depletion deduction, the term "mines" includes "deposits of waste or residue," but only if the extraction of ores from such deposits is treated as mining under Section 613(c) (Appendix A, *infra*). Section 613(c), relating to percentage depletion, expressly provides that mining includes the extraction of ores or minerals from the waste or residue of prior mining "by mine owners or operators" but that this does not

include any such extraction "by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." [5]

The Tax Court held (R. 67) that the "aggregates taken from the * * * [three] properties * * * were natural deposits that were mined by * * * [the taxpayer]." It did not consider whether the taxpayer was a purchaser of waste or residue. Since the court did not reach the purchaser question, it must necessarily have held (although it did not specifically say so) that the taxpayer's aggregates were "other natural deposits" separate and distinct from "mines" (and from "waste or residue").

We believe it is clear, and will show, that (1) the taxpayer's aggregates were not "other natural deposits"; (2) they were "waste or residue of prior mining"; and (3) the taxpayer was a purchaser of such waste or residue. In the final part of our brief we will point out why the Tax Court's finding that the aggregates were natural deposits is not binding on this Court.

B. *The taxpayer's aggregates deposits were not "other natural deposits" within the meaning of that term in Sections 611 and 613*

Under Sections 23(m) and 114(b)(4) of the 1939 Code, as amended (26 U.S.C. 1952 ed., Secs. 23 and 114) (the predecessors of Sections 611 and 613 of the 1954 Code) percentage depletion was allowed in the case of "mines and other natural deposits." Ques-

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[5] A more extensive discussion of the applicable statutory provisions is undertaken at a later point in this brief.

tions arose as to whether waste and residue, such as tailings piles and ore dumps from prior mining operations, could be the subject of depletion allowances by persons (other than the original miners) who later extracted minerals from the waste.[6] Several courts considered the problem. The issue in those cases was whether such waste or residue was included in the statutory term "mines and other natural deposits."

The judicial exploration of the statutory meaning of the term "other natural deposits" began with a decision of the Tenth Circuit, *Atlas Milling Co.* v. *Jones*, 115 F. 2d 61, certiorari denied, 312 U.S. 686. There, an underground miner brought lead-bearing ore to the surface, crushed it, removed the concentrates and dumped the partially denuded residue in a tailing pile. Later another party came on the land reworked the tailings by a new process and extracted the same material from them. The court concluded that the tailings were not a mine or other natural deposit within the meaning of the statute. It explained its conclusion by saying (p. 63):

> A "mine" is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. * * * Mining connotes the removal of minerals from a natural deposit. It does not embrace the re-working of mineral dumps artificially deposited from the residue remaining after the ore

[6] The 1939 Code did not contain specific reference to "waste or residue."

has been milled and concentrates removed therefrom.

* * * *

While tailings deposited on the surface of land may become appurtenant to the land, they in no true sense become a mine.

We are of the opinion that the word "mines" as used in § 23 [the predecessor of Section 611] * * * is limited to natural deposits and does not include a tailings dump deposited on the surface of the land, consisting of the residue of ore that has been severed and milled.

This Court first considered the problem directly[7] in *Consolidated Chollar G. & S. M. Co.* v. *Commissioner*, 133 F. 2d 440. There, residue from gold mines had been dumped on property other than that on which the mines were located.[8] No ore had been extracted from the residue. The taxpayer acquired the ore dumps some years after mining in the adjacent mines had ceased. The taxpayer began mining the ore from the tailing piles and claimed a depletion deduction. This Court disallowed the deduction, pointing out that even if the ore dumps could be regarded as a mine (p. 441) "they are made by man and not by nature" and therefore were not "other natural deposits."

In *Hoban* v. *Viley*, 204 F. 2d 459, this Court again

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[7] See *Commissioner* v. *Kennedy Min. & M. Co.*, 125 F. 2d 399 (C.A. 9th).

[8] A somewhat more complete statement of the facts appears in the opinion of the lower court, *Consolidated Chollar Gould & Savage Mining Co.* v. *Commissioner*, 46 B.T.A. 241.

considered whether mine tailings were "natural deposits." Mine tailings had been dumped into a stream and deposited by it below the mines. A partnership acquired rights to mine the tailings and claimed a depletion deduction, arguing that the tailings, which had been moved and integrated by the action of a stream for 36 years, were a deposit which was a mine or natural deposit. This Court again denied the deduction saying (p. 461):

> The only natural phenomenon contributing to the creation of the deposit was the action of floods in carrying the tailings downstream * * *.
>
> * * * *
>
> We * * * are of the opinion that the word "mines" or "natural deposits" as used in [the predecessor of Sections 611 and 613] * * * is limited to natural deposits, and does not include tailings severed from mines not owned by the taxpayer, and which are thereafter deposited on the earth's surface.

Contra: *Cordell* v. *Scofield* (W.D. Tex.), decided May 27, 1958 (1 A.F.T.R. 2d 1853).

Other Courts of Appeals have followed the trail assayed by the *Atlas*, *Consolidated* and *Hoban* cases. Thus, in *Chicago Mines Co.* v. *Commissioner*, 164 F. 2d 785, 787, certiorari denied, 333 U.S. 881, the Tenth Circuit denied a depletion deduction arising from the reworking of a mine dump and said (p. 787):

> Mining * * * connotes the removal of minerals from a natural deposit and does not include the reworking of mineral dumps from the surface of

> the earth artificially created and resulting from mining operations.

In *Kohinoor Coal Co.* v. *Commissioner*, 171 F. 2d 880, 885 (C.A. 3d), certiorari denied, 337 U.S. 924, the court held that a taxpayer who had rights to the waste dumps from a coal mine "did not [have] * * * any rights to * * * the natural deposits of the coal," and added, "refuse banks * * * are not a natural mineral deposit." See *Turkey Run Fuels* v. *United States*, 243 F. 2d 147, 149-150; and see pp. 152, 154 (dissent) (C.A. 3d).

The most recent case to hold that tailings and dumps are not natural deposits is *Soil Builders, Inc.* v. *United States*, 277 F. 2d 570 (C.A. 5th). The mining processes engaged in there were quite similar to those in this case. There, the original mining process consisted of digging hard rock phosphate from the ground and tumbling and washing it over a screen to remove unwanted matter. The material which passed through the screen, sand, clay and small colloidal phosphate particles, was discharged into the graund or into streams. The colloidal phosphate settled from a quarter to a half a mile from the mining activity. Some years later, it was found that the accumulated colloidal phosphate had commercial value. It was mined and depletion claimed. The court held that the water-deposited colloidal phosphate was not a natural deposit. It said (p. 573):

> The colloidal phosphate not only is not in its natural location; it is not even in its natural state. In effect, it is a refined product, refined

> by the removal from it of all sand (silica oxide) and non-phosphate clay. The refinement process and the removal process were one and the same. By this process a deposit was undoubtedly made, but it was not a natural deposit; it was man-made.

These several cases outline the tests for determining whether a mineral deposit comes within the term "mines and other natural deposits." In sum, the *Atlas Milling* case first indicated that a natural deposit did not include a tailings dump deposited on the surface of the land resulting from a residue of ore that had been severed and milled. This Court's *Consolidated* case added that "other natural deposits" cannot be made by man rather than by nature. Later, in its *Hoban* opinion, in the excerpts quoted above, this Court reaffirmed these rules. *Chicago Mines* said the deposit could not be artificially created or result from prior mining. Finally, the *Soil Builders* case pointed out that the material must be in its natural location, in its natural state and unrefined by the removal of any minerals.

The taxpayer's aggregates deposits do not fit the judicial definitions of "other natural deposits." The deposits remaining after the dredge had worked the property were customarily called tailings piles. (R. 66, 114, 117.) The dredging process severed the nature-deposited gold-bearing aggregates from the ground and separated the sand and gold from the gravel and cobbles. The gold was removed from the sand and the sand, gravel and cobbles thus refined were deposited by the dredger on the surface of the

land. (R. 87-89, 96-100.) The material, when deposited, was not in its natural location. Not only had it been moved about 200 to 350 feet from where it had been deposited in nature, but the various components of the aggregates were not deposited together. That is, while any one of the scoops on the forward ladder arm might dig a cubic yard of sand, gravel, cobbles and free gold in varying quantities, the sand was discharged at the end of the barge into the pond, some 225 feet from where it had been dug while the gravel and cobbles were simultaneously deposited at the end of the stacking ladder about 300 to 350 feet from where they were dug. The gold, of course, was not replaced on the surface at all. (R. 64, 66, 87-92, 97-100.) Nor were the aggregates deposited in their natural state. In place as a natural alluvial deposit, the aggregates were intermingled with sand, gravel and free gold filling the voids between the cobbles. Over the layer of aggregates was an over-burden of topsoil and vegetation. The dredge deposited sand and soil (intermingled as they had not been in nature) in a layer on top of bedrock; gravel and cobbles were then dropped in a separate layer on top of the sand without fine particles filling the voids between the larger ones: there was no gold present; and the depth of the aggregate above bedrock had been increased by about 40 percent. (R. 63-66, 89-90, 96-100, 118.) A further indication of the artificial nature of the post-dredging aggregate deposits on the properties the taxpayer worked is the testimony as to the differing processing which the taxpayer was required to undertake with natural

materials and the dredged materials. (R. 130-131, 134.) Under the tests established by the decisions, contrary to the holding of the Tax Court, the taxpayer's aggregates were artificial deposits resulting from prior mining and not "other natural deposits." *Atlas Milling Co.* v. *Jones*, *supra; Consolidated Chollar G. & S. M. Co.* v. *Commissioner*, *supra; Hoban* v. *Viley*, *supra; Chicago Mines Co.* v. *Commissioner*, *supra; Kohinoor Coal Co.* v. *Commissioner*, *supra; Soil Builders, Inc.* v. *United States*, *supra.*

The Tax Court believed this case to be indistinguishable from *Pacific Cement & Aggregates, Inc.* v. *Commissioner*, 31 T.C. 136. We respectfully submit this analysis is incorrect. We have pointed out above the elements which courts, including this one, have found to indicate that a deposit is not a natural deposit. It is on precisely the most important of those points that this case differs from *Pacific Cement.* Thus, as indicated above, the dredger droppings were customarily called tailings piles. The *Atlas* case said tailings were not a natural deposit. In *Pacific Cement*, however, there is no indication of what the dredger tailings were. In fact, in *Pacific Cement* the *Atlas* case was distinguished on the ground that in *Atlas* (31 T.C., p. 139) "there actually were tailings." See *Hoban* v. *Viley*, *supra.* Further, while here the evidence shows that the dredger dug the alluvium, and transported selected portions of it over 300 feet, in *Pacific Cement* the dredge was about 100 feet long and the material dredged was dumped into the pond (31 T.C., p. 140) "in substantially the same place where it had picked it up." Finally, unlike this

case, in *Pacific Cement* there was no showing that the aggregates were deposited separately, in different locations and in different stratification than they occurred in nature. On the contrary, the *Pacific Cement* opinion states that while gravel and sand were separated on the dredge, after the gold was extracted (p. 138), "the gravel and sand were then intermingled and dumped back into the pond." Cf. *Soil Builders, Inc.* v. *United States, supra.* Quite apart from the correctness of the *Pacific Cement* opinion, we submit that it cannot be said here, as it was there, that when the dredging was completed (31 T.C., p. 141), "they were the identical aggregates which existed when the process had been commenced." Here, they were not. Therefore, they could not be "other natural deposits."

C. ***The taxpayer's aggregates were "waste or residue of prior mining" as that term is used in Section 613.***

The taxpayer's aggregates were "waste or residue of prior mining" as that term is used in Sections 611 and 613. Although that phrase did not appear in the 1939 Code, courts had occasion to consider what constituted waste and residue in developing a definition of the term "mines and other natural resources." Thus, in *Atlas Milling Co.* v. *Jones, supra,* the court indicated that tailings from mineral production were residue. In *Chicago Mines Co.* v. *Commissioner, supra,* the court described tailings as waste material. In *Commissioner* v. *Kennedy Min. & M. Co.*, 125 F. 2d 399, 400, note 2, this Court described tailings as ores

which had previously been worked. See also *Hoban* v. *Viley*, *supra*. In addition, in *Kohinoor Coal Co.* v. *Commissioner*, supra, the court said that a waste dump was material (p. 881) "thrown aside" by prior mining operations.

When the three properties here were dredged for gold, the gold alone was extracted and the remaining aggregates were both residue [9] and waste [10] of the gold mining operation. As we have pointed out above, the aggregates discharged after having been worked by the dredger were customarily called tailings, the generic term for waste or residue from mining activities.[11] This Court's *Consolidated* opinion held that the mere severance and piling of ore-bearing rock, without the extraction of a mineral, was sufficient to make the mine tailings residue. Here, the case is stronger because the alluvium deposits were not only severed from their natural state and location, but gold was extracted from the ore-bearing aggregates.

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[9] Webster's New Collegiate Dictionary (2d ed.) defines "residue" as:

> 1. That which remains after a part is taken, separated or designated; remnant, remainder.

[10] Webster's New Collegiate Dictionary, *supra*, defines "waste" as that which is—

> Thrown away as worthless after being used or spent;

[11] Webster's New Collegiate Dictionary, *supra*, defines "tailings" as:

> 1. Refuse material separated as residue in the preparation of various products, as in * * * treating ores.

Although the Tax Court did not independently characterize the *taxpayer's* aggregates as not being "waste or residue", it quoted extensively from its earlier opinion in *Pacific Cement & Aggregates, Inc.* v. *Commissioner*, *supra*, which stated that in that case (p. 140) "there is nothing that resembles a dump or residue." In *Pacific Cement* the Tax Court reasoned that the dredger tailings could not be residue because there had been no prior mining of the property for aggregates. This represents an erroneous view of the law. The Court of Appeals decisions cited above did not develop a concept of waste or residue in relation to activity in extracting a *particular mineral.* Instead, they held that waste or residue was the unwanted by-product of prior mineral production.

The Tax Court's *Pacific Cement* case, in holding that the dredger droppings there were not waste or residue because they had never been mined for aggregates, is directly in conflict with the same court's earlier decision in *Consolidated Chollar Gould & Savage Mining Co.* v. *Commissioner*, 46 B.T.A. 241, affirmed, 133 F. 2d 440 (C.A. 9th). In its opinion in *Consolidated*, the Board rejected (p. 245) as "immaterial" the taxpayer's argument that an ore dump was a mine (and thus a natural deposit) because the dump had never been worked for the kind of ore which was extracted from it by the mining operation in question. We submit that the *Consolidated* reasoning is correct. Clearly, whether a deposit is waste or residue is to be determined in relation to the *previous* mining activity, not in relation to the

current activity alone as the Tax Court held in *Pacific Cement*. For the same reason, it is not necessary that the past and present mining activities be the same.

The 1954 Code makes apparent that whether or not a given deposit has been previously mined for the type of mineral being mined is *not* material to the question of whether the deposit is waste or residue, since the Code makes no such distinction. On the contrary, it speaks of "waste or residue of *prior* mining" (emphasis added) without limitation as to the mineral produced by either the prior or current extraction processes. Section 613(c)(3). The Committee Reports relating to Sections 611 and 613 of the 1954 Code also contain no intimation that any distinction exists as to waste or residue in relation to continuity of the production of a specific kind of mineral. See, e.g., S. Rep. No. 1622, 83d Cong., 2d Sess., p. 329 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4970).

D. ***The taxpayer is a "purchaser of * * * waste or residue or of the rights to extract * * * minerals therefrom" and as such is specifically disqualified under Section 613 from the depletion deduction it seeks***

1. As noted, the 1954 Code makes specific provision for "deposits of waste or residue" from prior mining. Sections 611(a) and 613(c). The purpose of this provision is to "extend percentage depletion at the appropriate rates to mine owners for minerals recovered from the residue that had accumulated from their mine * * * to encourage the production of minerals from these accumulations as well as from the mine it-

self." H. Rep. No. 1337, 83d Cong., 2d Sess., p. 59 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4085). "The effect" of the change is to extend depletion "to the extraction of ores or minerals from waste or residue of prior mining" on the theory that a waste pile is a "part of the property from which it was extracted." *Id.* p. A 183 (3 U.S.C. Cong. & Adm. News (1954) 4322-4323).

The Code carries out this purpose by a series of involuted definitions under which (1) mining includes the extraction of minerals from the waste or residue of prior mining (2) except as to any such extraction of the mineral or ore "by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." [12] This effectively limits percentage de-

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[12] Section 611(a) allows a deduction for depletion "In the case of mines, * * * other natural deposits and timber." The section defines the term "mines," for purposes of the depletion deduction as "includ[ing] deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c)." Section 613(c)(2) defines what is treated as mining to include "the extraction of the ores or minerals from the ground." That phrase is in turn defined by Section 613(c)(3). The first sentence or subsection (c)(3) says that the phrase "extraction of the ores or minerals from the ground" includes the "extraction by mine owners * * * of * * * minerals from the waste or residue of prior mining." The second sentence of subsection (c)(3), however, says that inclusion of "waste or residue" in the phrase "extraction of the ores or minerals from the ground" (which is accomplished by the first sentence) "shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." Thus, if the taxpayer *is* a purchaser of waste or residue, the extraction of such waste or residue, by definition, is not treated as mining in Section

pletion on minerals extracted from waste or residue to the owner or operator who, in mining, created the waste or residue. As to such a party, the waste or residue is considered a part of the mine and the extraction of mineral therefrom a continuation of the original mining activity. But the situation is different as to other parties, whether they purchase the waste or residue directly or only "the rights to extract ores or minerals" from the waste or residue. Thus, even a lessee is not entitled to percentage depletion on the mineral extracted from waste or residue.

The natural construction of the statutory language is in accord with the Congressional intent already mentioned and, moreover, the legislative reports further emphasize the contrast between the original miner and any other party, referred to as a purchaser. H. Rep. No. 1337, *supra*, p. A 186 (3 U.S.C. Cong. & Adm. News (1954) 4325) explains: "No depletion allowance shall be permitted * * * in respect of the working of waste or residue by a person other than the mine owner or operator, such as the purchaser of the waste or residue or of the rights to extract ores or minerals therefrom." See also S. Rep. No. 1622, *supra*, pp. 79, 333 (3 U.S.C. Cong. & Adm. News (1954) 4712, 4973-4974). The Reports further explain, "Thus where a mine owner is engaged in the mining and sale of ores or minerals * * * produced by him from waste * * * [from the original mine

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613(c), and therefore the deposits of such waste or residue are not "mines" within the definition of that word in Section 611(a) and so are not deposits which are subject to depletion within the Code.

workings], the gross income from" the waste forms a part of the gross income from the property. S. Rep. No. 1622, *supra*, p. 329 (3 U.S.C. Cong. & Adm. News (1954) 4970). But "this provision is not applicable to any such extraction of the mineral or ore by the purchaser * * * [and] the term 'purchaser' includes a person who acquires such waste or residue in a taxable transaction." S. Rep. No. 1622, *supra*, p. 333 (3 U.S.C. Cong. & Adm. News, supra, pp. 4973-4974).

Thus, percentage depletion is permitted in relation to waste and residue only when the mining is done by the owner or operator who originally mined the property (except for tax-free successors in interest)[13] on the theory that the mining of tailings and waste is but a continuation and completion of the original mining process. See *Kohinoor* v. *Commissioner*, *supra;* Treasury Regulations on Income Tax (1954 Code), Section 1.613-3(f).

2. There can be no doubt that the taxpayer was a purchaser either of the waste or residue as such or of the rights to extract ores or minerals therefrom. Whether the agreements involved here were sales contracts or leases is immaterial. It is sufficient that the taxpayer was a "purchaser" within the meaning of the statute.

The agreement under which it operated the Featherston property recited (R. 34-35):

> Whereas, as a result of the dredging operations by * * * [the dredging company], sand and

[13] See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 331 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4973-4974).

> gravel have been made available, which sand and gravel * * * [the taxpayer] desires to purchase to the extent herein described.
>
> * * * *
>
> 2. * * * [the taxpayer] agrees to pay annually to * * * [the dredging company] for a minimum of 100,000 tons of said sand and gravel, whether or not said sand and gravel are actually mined or removed.

The taxpayer operated on the Putnam Ranch under two agreements. The first, entitled (R. 39) "Option to Purchase Gravel," provided in part (R. 39-40)—

> L. E. Putnam and Edna Putnam Albertson * * * agree to give to * * * [the taxpayer] an Exclusive option to purchase sand, gravel and rock from the Dredger operations on the property * * *.
>
> * * * *
>
> Payment for materials to be made monthly based upon the quantities removed by the * * * [taxpayer].

The second agreement on the Putnam Ranch provided, in part (R. 41-42)—

> the parties hereto are desirous of continuing * * * [the first] agreement and making certain modifications thereof;
>
> * * * *
>
> 1. * * * that * * * [the taxpayer] has purchased concrete aggregate material situate on adjoining properties; * * * the * * * [Putnams] shall receive from [the taxpayer] the cash sum to be in full and final payment for all royalties

> to which * * * [the Putnams] would otherwise be entitled for concrete aggregates excavated * * *.
>
> * * * *
>
> 3. * * * [the taxpayer] shall continue to pay for such materials so removed the maximum amount provided for in the [first] agreement * * * or a minimum sum of $1,000.00 per year, whichever amount is greater * * *.

The taxpayer operated on the Wright property under an agreement entitled an "Agreement of Sale" which provided, in part (R. 43-44)—

> This agreement of sale is * * * entered into * * * between Percy F. Wright and Natalie R. Wright, his wife, (hereinafter termed The Vendors) * * * and Claude C. Wood Company, (hereinafter termed The Purchaser) * * *
>
> Whereas, The Vendors now own * * * land * * * on which land, in years past, mining operations have been conducted, and
>
> Whereas, as a result of said mining operations, there is now present on the surface of this land a quantity of rock, gravel, sand and dredger tailings, and
>
> * * * *
>
> Now, Therefore, the Vendors and the Purchaser make and enter into this agreement of sale of the said rock, gravel, sand and dredger tailings * * *.

Thus, it appears that this taxpayer is a "purchaser * * * of "waste or residue or of the rights to extract ores or minerals therefrom" as that term is used in

Section 613(c)(3). The taxpayer did not own the three properties and it did not do the "prior mining" for gold which resulted in the original displacement of the rock, sand and gravel. It is, therefore, a party to whom the expanded definition of "mines" (and, inferentially, "natural deposits") does not apply and so it cannot deduct percentage depletion on "waste and residue" under Sections 611 and 613. The Tax Court erred in holding that it was entitled to the depletion deduction.

E. *The Tax Court's finding that the aggregates were natural deposits is not binding on this Court*

The Tax Court found, purportedly as a fact (R. 67), that "The aggregates taken from the Putnam, Wright and Featherston properties in the year in question were natural deposits that were mined by petitioner." We point out, however, that this is not a case where the Court's scope of review is limited to determining whether a finding is supported by the evidence. Such a factual inquiry arises only where the trial court has applied the proper legal standard established by the statute (*United States* v. *Wagner Quarries Co.*, 260 F. 2d 907 (C.A. 6th), as this Court has often recognized (see, e.g., *Riddell* v. *Victorville Lime Rock Co.*, 292 F. 2d 427; *Riddell* v. *California Portland Cement Co.*, 297 F. 2d 345).

Here the Tax Court plainly failed to apply the proper legal standard, and therefore erred as a matter of law. In the first place, the Tax Court did not apply the proper test of "natural deposits"—as evidenced by the numerous cases in point we discussed

earlier. Secondly, there is no direct indication that the Tax Court considered the statutory provisions relating to waste and residue and their concomitant limitation in relation to purchasers thereof or of rights in respect thereof. Assuming that it did and nevertheless held that the taxpayer is entitled to a percentage depletion allowance on the ground that the aggregates were natural deposits rather than waste or residue, the court compounded its error with respect to the meaning of "natural deposits" by failing to recognize and apply the legislative intent with respect to the waste or residue of prior mining.

Under the circumstances, the Tax Court's finding that the aggregates were natural deposits does not confine the issue to a factual inquiry. Indeed, there is no conflict in the evidence; the only question is whether the Tax Court correctly applied the law to the facts. The Tax Court's finding that the aggregates were natural deposits would, we believe, be clearly erroneous even if viewed from a purely factual standpoint.

CONCLUSION

For the reasons stated, the decision of the Tax Court is incorrect and should be reversed.

Respectfully submitted,

LOUIS F. OBERDORFER,
Assistant Attorney General.

LEE A. JACKSON,
MELVA M. GRANEY,
MICHAEL MULRONEY,
Attorneys,
Department of Justice,
Washington 25, D. C.

MARCH, 1963.

CERTIFICATE OF SERVICE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:.....day of....., 1963.

Attorney

APPENDIX A

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

(26 U.S.C. 1958 ed., Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an

amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * *

(c) *Definition of Gross Income from Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) *Extraction of the ores or minerals from the ground.*—The term "extraction of

the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

* * * *

(26 U.S.C. 1958 ed., Sec. 613.)

APPENDIX B

SCHEDULE OF EXHIBITS IDENTIFIED, OFFERED, AND RECEIVED IN EVIDENCE:

Exhibit	Description	Identified Record Page	Offered Record Page	Received Record Page
Joint				
1-A	Tax Return	19	81	81
2-B	Articles of Incorporation	19	81	81
3-C	Purchase Agreement	19	81	81
4-D	Option to Purchase	20	81	81
5-E	Purchase Agreement	20	81	81
6-F	Agreement of Sale	20	81	81
7-G	Schedule	21	81	81
8-H	Photograph	51	81	81
9-I	Diagram	51	81	81
10-J	Schedule	51	81	81
11-K	Schedule	51	81	81
Petitioner's				
12	Photograph	123	124	124

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